



8011-01

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-83952; File No. SR-NSCC-2017-806]

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of No Objection to an Advance Notice, as Modified by Amendment No. 1, to Amend the Loss Allocation Rules and Make Other Changes

August 27, 2018

On December 18, 2017, National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) advance notice SR-NSCC-2017-806 pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act entitled the Payment, Clearing, and Settlement Supervision Act of 2010 (“Clearing Supervision Act”)¹ and Rule 19b-4(n)(1)(i) under the Securities Exchange Act of 1934 (“Act”)² to amend NSCC’s loss allocation rules, accelerate the return of certain deposits to former Members, and make other conforming and technical changes.³ The advance notice was published for

¹ 12 U.S.C. 5465(e)(1).

² 17 CFR 240.19b-4(n)(1)(i).

³ On December 18, 2017, NSCC filed the advance notice as proposed rule change SR-NSCC-2017-018 with the Commission pursuant to Section 19(b)(1) of the Act and Rule 19b-4 thereunder (“Proposed Rule Change”). 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4, respectively. The Proposed Rule Change was published in the Federal Register on January 8, 2018. Securities Exchange Act Release No. 82428 (January 2, 2018), 83 FR 897 (January 8, 2018) (SR-NSCC-2017-018). On February 8, 2018, the Commission designated a longer period within which to approve, disapprove, or institute proceedings to determine whether to approve or disapprove the Proposed Rule Change. Securities Exchange Act Release No. 82670 (February 8, 2018), 83 FR 6626 (February 14, 2018) (SR-DTC-2017-022, SR-FICC-2017-022, SR-NSCC-2017-018). On March 20, 2018, the Commission instituted proceedings to determine whether to approve or disapprove the Proposed Rule Change. Securities Exchange Act Release No. 82910 (March 20, 2018), 83 FR 12968 (March 26, 2018) (SR-NSCC-2017-018). On June 25, 2018, the Commission designated a longer period for Commission action on the

comment in the Federal Register on January 30, 2018.⁴ In that publication, the Commission also extended the review period of the advance notice for an additional 60 days, pursuant to Section 806(e)(1)(H) of the Clearing Supervision Act.⁵ On April 10, 2018, the Commission required additional information from NSCC pursuant to Section 806(e)(1)(D) of the Clearing Supervision Act,⁶ which tolled the Commission's period of review of the advance notice until 60 days from the date the information required by the Commission was received by the Commission.⁷ On June 28, 2018, NSCC filed

proceedings to determine whether to approve or disapprove the Proposed Rule Change. Securities Exchange Act Release No. 83510 (June 25, 2018), 83 FR 30791 (June 29, 2018) (SR-DTC-2017-022, SR-FICC-2017-022, SR-NSCC-2017-018). On June 28, 2018, NSCC filed Amendment No. 1 to the Proposed Rule Change, which was published in the Federal Register on July 19, 2018. Securities Exchange Act Release No. 83633 (July 13, 2018), 83 FR 34227 (July 19, 2018) (SR-NSCC-2017-018). NSCC submitted a courtesy copy of Amendment No. 1 to the Proposed Rule Change through the Commission's electronic public comment letter mechanism. Accordingly, Amendment No. 1 to the Proposed Rule Change has been publicly available on the Commission's website at <https://www.sec.gov/rules/sro/nscc.htm> since June 29, 2018. The Commission did not receive any comments. The proposal, as set forth in both the advance notice and the Proposed Rule Change, each as modified by Amendments No. 1, shall not take effect until all required regulatory actions are completed.

⁴ Securities Exchange Act Release No. 82584 (January 24, 2018), 83 FR 4377 (January 30, 2018) (SR-NSCC-2017-806) ("Notice").

⁵ Pursuant to Section 806(e)(1)(H) of the Clearing Supervision Act, the Commission may extend the review period of an advance notice for an additional 60 days, if the changes proposed in the advance notice raise novel or complex issues, subject to the Commission providing the clearing agency with prompt written notice of the extension. 12 U.S.C. 5465(e)(1)(H). The Commission found that the advance notice raised complex issues and, accordingly, extended the review period of the advance notice for an additional 60 days until April 17, 2018. See Notice, supra note 4.

⁶ 12 U.S.C. 5465(e)(1)(D).

⁷ See 12 U.S.C. 5465(e)(1)(E)(ii) and (G)(ii); see Memorandum from the Office of Clearance and Settlement Supervision, Division of Trading and Markets, titled

Amendment No. 1 to the advance notice to amend and replace in its entirety the advance notice as originally filed on December 18, 2017.⁸ On July 6, 2018, the Commission received a response to its request for additional information in consideration of the advance notice, which, in turn, added a further 60 days to the review period pursuant to Section 806(e)(1)(E) and (G) of the Clearing Supervision Act.⁹ The Commission did not receive any comments. This publication serves as notice that the Commission does not object to the proposed changes set forth in the advance notice, as modified by Amendment No. 1 (hereinafter, “Advance Notice”).

I. Description of the Advance Notice

The Advance Notice consists of proposed changes to NSCC’s Rules and Procedures (“Rules”)¹⁰ in order to (1) modify the loss allocation process; (2) align NSCC’s loss allocation rules with the three clearing agencies of The Depository Trust & Clearing Corporation (“DTCC”) – The Depository Trust Company (“DTC”), Fixed

“Commission’s Request for Additional Information,” available at <https://www.sec.gov/rules/sro/nsc-an.htm>.

⁸ Securities Exchange Act Release No. 83748 (July 31, 2018), 83 FR 38375 (August 6, 2018) (SR-NSCC-2017-806) (“Notice of Amendment No. 1”). NSCC submitted a courtesy copy of Amendment No. 1 to the advance notice through the Commission’s electronic public comment letter mechanism. Accordingly, Amendment No. 1 to the advance notice has been publicly available on the Commission’s website at <https://www.sec.gov/rules/sro/nsc-an.htm> since June 29, 2018.

⁹ 12 U.S.C. 5465(e)(1)(E) and (G); see Memorandum from the Office of Clearance and Settlement Supervision, Division of Trading and Markets, titled “Response to the Commission’s Request for Additional Information,” available at <https://www.sec.gov/rules/sro/nsc-an.htm>.

¹⁰ Each capitalized term not otherwise defined herein has its respective meaning as set forth in the Rules, available at http://www.dtcc.com/~media/Files/Downloads/legal/rules/nsc_rules.pdf.

Income Clearing Corporation (“FICC”) (including the Government Securities Division (“FICC/GSD”) and the Mortgage-Backed Securities Division (“FICC/MBSD”)), and NSCC (collectively, the “DTCC Clearing Agencies”);¹¹ (3) reduce the time within which NSCC is required to return a former Member’s Clearing Fund deposit; and (4) make conforming and technical changes. Each of these proposed changes is described below. A detailed description of the specific rule text changes proposed in this Advance Notice can be found in the Notice of Amendment No. 1.¹²

A. Changes to the Loss Allocation Process

NSCC’s loss allocation rules currently provide that in the event NSCC ceases to act¹³ for a Member, the amount on deposit to the Clearing Fund from the defaulting Member, along with any other resources of, or attributable to, the defaulting Member that NSCC may access under the Rules, are the first source of funds NSCC would use to cover any losses that may result from the closeout of the defaulting Member’s guaranteed positions. If these amounts are not sufficient to cover all losses incurred, then NSCC will apply the following available resources, in the following order: (1) as provided in

¹¹ DTCC is a user-owned and user-governed holding company and is the parent company of DTC, FICC, and NSCC. DTCC operates on a shared services model with respect to the DTCC Clearing Agencies. Most corporate functions are established and managed on an enterprise-wide basis pursuant to intercompany agreements under which it is generally DTCC that provides a relevant service to a DTCC Clearing Agency.

¹² See Notice of Amendment No. 1, supra note 8.

¹³ When NSCC restricts a Member’s access to services generally, NSCC is said to have “ceased to act” for the Member. Rule 46 (Restrictions on Access to Services) sets out the circumstances under which NSCC may cease to act for a Member, and Rule 18 (Procedures for When the Corporation Declines or Ceases to Act) sets out the types of actions NSCC may take when it ceases to act for a Member. Supra note 10.

Addendum E of the Rules, NSCC's corporate contribution of at least 25 percent of NSCC's retained earnings existing at the time of a Member impairment, or such greater amount as the Board of Directors may determine; and (2) if a loss still remains, as provided in Rule 4, the required Clearing Fund deposits of non-defaulting Members on the date of default.

Pursuant to current Section 5 of Rule 4, if, as a result of applying the Clearing Fund deposit of a Member, the Member's actual Clearing Fund deposit is less than its Required Deposit, it will be required to eliminate such deficiency in order to satisfy its Required Deposit amount. Pursuant to current Section 4 of Rule 4, Members can also be assessed for non-default losses incident to the operation of the clearance and settlement business of NSCC. Pursuant to current Section 8 of Rule 4, Members may withdraw from membership within specified timeframes after a loss allocation charge to limit their obligation for future assessments.

NSCC proposes to change the manner in which each of the aspects of the loss allocation process described above would be employed. The proposal would clarify or adjust certain elements and introduce certain new loss allocation concepts, as further discussed below. In addition, the proposal would address the loss allocation process as it relates to losses arising from or relating to multiple default or non-default events in a short period of time, also as described below.

NSCC proposes six key changes to enhance NSCC's loss allocation process. Specifically, NSCC proposes to make changes regarding (1) the Corporate Contribution, (2) the Event Period, (3) the loss allocation round and notice, (4) the look-back period,

(5) the loss allocation withdrawal notice and cap, and (6) the governance around non-default losses, each of which is discussed below.

(1) Corporate Contribution

Addendum E of the Rules currently provides that NSCC will contribute no less than 25 percent of its retained earnings (or such higher amount as the Board of Directors shall determine) to a loss or liability that is not satisfied by the impaired Member's Clearing Fund deposit. Under the proposal, NSCC would amend the calculation of its corporate contribution from a percentage of its retained earnings to a mandatory amount equal to 50 percent of the NSCC General Business Risk Capital Requirement.¹⁴

NSCC's General Business Risk Capital Requirement, as defined in NSCC's Clearing Agency Policy on Capital Requirements,¹⁵ is, at a minimum, equal to the regulatory capital that NSCC is required to maintain in compliance with Rule 17Ad-22(e)(15) under the Act.¹⁶ The proposed Corporate Contribution would be held in addition to NSCC's General Business Risk Capital Requirement.

Under the current Addendum E of the Rules, NSCC has the discretion to contribute amounts higher than the specified percentage of retained earnings, as determined by the Board of Directors, to any loss or liability incurred by NSCC as result

¹⁴ NSCC calculates its General Business Risk Capital Requirement as the amount equal to the greatest of (1) an amount determined based on its general business profile, (2) an amount determined based on the time estimated to execute a recovery or orderly wind-down of NSCC's critical operations, and (3) an amount determined based on an analysis of NSCC's estimated operating expenses for a six month period.

¹⁵ See Securities Exchange Act Release No. 81105 (July 7, 2017), 82 FR 32399 (July 13, 2017) (SR-DTC-2017-003, SR-NSCC-2017-004, SR-FICC-2017-007).

¹⁶ 17 CFR 240.17Ad-22(e)(15).

of a Member's impairment. This option would be retained and expanded under the proposal so that NSCC can voluntarily apply amounts greater than the Corporate Contribution against any loss or liability (including non-default losses) of NSCC, if the Board of Directors, in its sole discretion, believes such to be appropriate under the factual situation existing at the time.

Currently, the Rules do not require NSCC to contribute its retained earnings to losses and liabilities other than those from Member impairments. Under the proposal, NSCC would apply its Corporate Contribution to non-default losses as well. The proposed Corporate Contribution would apply to losses arising from Defaulting Member Events and Declared Non-Default Loss Events, as defined in the proposed change, and would be a mandatory contribution by NSCC prior to any allocation of the loss among NSCC's Members.¹⁷

As proposed, if the Corporate Contribution is fully or partially used against a loss or liability relating to an Event Period, the Corporate Contribution would be reduced to the remaining unused amount, if any, during the following 250 business days in order to permit NSCC to replenish the Corporate Contribution.¹⁸ Under the proposal, Members would receive notice of any such reduction to the Corporate Contribution.

¹⁷ NSCC does not propose to apply the Corporate Contribution if the Clearing Fund is used as a liquidity resource; however, if NSCC uses the Clearing Fund as a liquidity resource for more than 30 calendar days, as set forth in proposed Section 2 of Rule 4, then NSCC would have to consider the amount used as a loss to the Clearing Fund incurred as a result of a Defaulting Member Event and allocate the loss pursuant to proposed Section 4 of Rule 4, which would then require the application of a Corporate Contribution.

¹⁸ NSCC states that 250 business days would be a reasonable estimate of the time frame that NSCC would be required to replenish the Corporate Contribution by equity in accordance with NSCC's Clearing Agency Policy on Capital

(2) Event Period

NSCC states that in order to clearly define the obligations of NSCC and its Members regarding loss allocation and to balance the need to manage the risk of sequential loss events against Members' need for certainty concerning their maximum loss allocation exposures, NSCC proposes to introduce the concept of an Event Period to the Rules to address the losses and liabilities that may arise from or relate to multiple Defaulting Member Events and/or Declared Non-Default Loss Events that arise in quick succession. Specifically, the proposal would group Defaulting Member Events and Declared Non-Default Loss Events occurring within a period of 10 business days ("Event Period") for purposes of allocating losses to Members in one or more rounds, subject to the limitations of loss allocation as explained below.¹⁹

In the case of a loss or liability arising from or relating to a Defaulting Member Event, an Event Period would begin on the day NSCC notifies Members that it has ceased to act for the Defaulting Member (or the next business day, if such day is not a business day). In the case of a loss or liability arising from or relating to a Declared Non-Default Loss Event, an Event Period would begin on the day that NSCC notifies Members of the Declared Non-Default Loss Event (or the next business day, if such day is not a business day). If a subsequent Defaulting Member Event or Declared Non-

Requirements, including a conservative additional period to account for any potential delays and/or unknown exigencies in times of distress.

¹⁹ NSCC states that having a 10 business day Event Period would provide a reasonable period of time to encompass potential sequential Defaulting Member Events or Declared Non-Default Loss Events that are likely to be closely linked to an initial event and/or a severe market dislocation episode, while still providing appropriate certainty for Members concerning their maximum exposure to mutualized losses with respect to such events.

Default Loss Event occurs during an Event Period, any losses or liabilities arising out of or relating to any such subsequent event would be resolved as losses or liabilities that are part of the same Event Period, without extending the duration of such Event Period. An Event Period may include both Defaulting Member Events and Declared Non-Default Loss Events, and there would not be separate Event Periods for Defaulting Member Events or Declared Non-Default Loss Events occurring during overlapping 10 business day periods.

The amount of losses that may be allocated by NSCC, subject to the required Corporate Contribution, and to which a Loss Allocation Cap would apply for any Member that elects to withdraw from membership in respect of a loss allocation round, would include any and all losses from any Defaulting Member Events and any Declared Non-Default Loss Events during the Event Period, regardless of the amount of time, during or after the Event Period, required for such losses to be crystallized and allocated.²⁰

(3) Loss Allocation Round and Loss Allocation Notice

Under the proposal, a loss allocation “round” would mean a series of loss allocations relating to an Event Period, the aggregate amount of which is limited by the sum of the Loss Allocation Caps of affected Members (a “round cap”). When the aggregate amount of losses allocated in a round equals the round cap, any additional losses relating to the applicable Event Period would be allocated in one or more

²⁰ Under the proposal, each Member that is a Member on the first day of an Event Period would be obligated to pay its pro rata share of losses and liabilities arising out of or relating to each Defaulting Member Event (other than a Defaulting Member Event with respect to which it is the Defaulting Member) and each Declared Non-Default Loss Event occurring during the Event Period.

subsequent rounds, in each case subject to a round cap for that round. NSCC may continue the loss allocation process in successive rounds until all losses from the Event Period are allocated among Members that have not submitted a Loss Allocation Withdrawal Notice in accordance with proposed Section 6 of Rule 4.

Each loss allocation would be communicated to Members by the issuance of a notice that advises each Member of the amount being allocated to it (“Loss Allocation Notice”). Each Member’s pro rata share of losses and liabilities to be allocated in any round would be equal to (1) the average of its Required Fund Deposit for the 70 business days preceding the first day of the applicable Event Period or such shorter period of time that the Member has been a Member (each Member’s “Average RFD”), divided by (2) the sum of Average RFD amounts of all Members subject to loss allocation in such round.

Each Loss Allocation Notice would specify the relevant Event Period and the round to which it relates. The first Loss Allocation Notice in any first, second, or subsequent round would expressly state that such Loss Allocation Notice reflects the beginning of the first, second, or subsequent round, as the case may be, and that each Member in that round has five business days from the issuance of such first Loss Allocation Notice for the round to notify NSCC of its election to withdraw from membership with NSCC pursuant to proposed Section 6 of Rule 4, and thereby benefit from its Loss Allocation Cap.²¹ In other words, the proposed change would link the Loss

²¹ Pursuant to current Section 8 of Rule 4, the time period for a Member to give notice of its election to terminate its business with NSCC in respect of a pro rata charge is 10 business days after receiving notice of a pro rata charge. Supra note 10. NSCC states that it would be appropriate to shorten such time period from 10 business days to five business days because NSCC needs timely notice of which

Allocation Cap to a round in order to provide Members the option to limit their loss allocation exposure at the beginning of each round. After a first round of loss allocations with respect to an Event Period, only Members that have not submitted a Loss Allocation Withdrawal Notice, in accordance with proposed Section 6 of Rule 4, would be subject to further loss allocation with respect to that Event Period.

NSCC's current loss allocation provisions provide that if a charge is made against a Member's actual Clearing Fund deposit, and as result thereof the Member's deposit is less than its Required Deposit, the Member will, upon demand by NSCC, be required to replenish its deposit to eliminate the deficiency within such time as NSCC shall require. Under the proposal, Members would receive two business days' notice of a loss allocation, and be required to pay the requisite amount no later than the second business day following the issuance of such notice.²²

(4) Look-Back Period

Currently, the Rules calculate a Member's pro rata share for purposes of loss allocation based on the Member's activity in each of the various services or Systems offered by NSCC.²³ NSCC states that it would be more appropriate to determine a Member's pro rata share of losses and liabilities based on the amount of risk that the

Members would remain in its membership for purposes of calculating the loss allocation for any subsequent round. NSCC states that five business days would provide Members with sufficient time to decide whether to cap their loss allocation obligations by withdrawing from their membership in NSCC.

²² NSCC states that allowing Members two business days to satisfy their loss allocation obligations would provide Members sufficient notice to arrange funding, if necessary, while allowing NSCC to address losses in a timely manner.

²³ NSCC states that its current loss allocation rules pre-date NSCC's move to a risk-based margining methodology.

Member brings to NSCC, which is represented by the Member's Required Deposit (NSCC proposes that "Required Deposits" be renamed "Required Fund Deposits," as described below). Accordingly, NSCC proposes to calculate each Member's pro rata share of losses and liabilities to be allocated in any round (as described above) to be equal to (1) the Member's Average RFD divided by (2) the sum of Average RFD amounts for all Members that are subject to loss allocation in such round. The proposed rule would define a Member's Average RFD as the average of the Member's Required Fund Deposit for the 70 business days²⁴ preceding the first day of the applicable Event Period or such shorter period of time that the Member has been a Member. Additionally, if a Member withdraws from membership pursuant to proposed Section 6 of Rule 4, NSCC proposes that the Member's Loss Allocation Cap be equal to the greater of (1) its Required Fund Deposit on the first day of the applicable Event Period or (2) its Average RFD.

NSCC states that employing a backward-looking average to calculate a Member's loss allocation pro rata share and Loss Allocation Cap would disincentivize Member behavior that could heighten volatility or reduce liquidity in markets in the midst of a financial crisis. Specifically, NSCC states that the proposed look-back period would discourage a Member from reducing its settlement activity during a time of stress primarily to limit its loss allocation pro rata share, which, as proposed, would now be based on the Member's average settlement activity over the look-back period rather than

²⁴ NSCC states that having a look-back period of 70 business days is appropriate because it would be long enough to enable NSCC to capture a full calendar quarter of a Member's activities, including quarterly option expirations, and smooth out the impact from any abnormalities and/or arbitrariness that may have occurred, but not too long that the Member's business strategy and outlook could have shifted significantly, resulting in material changes to the size of its portfolios.

its settlement activity at a point in time that the Member may not be able to estimate. Similarly, NSCC states that taking a backward-looking average into consideration when determining a Member's Loss Allocation Cap would also deter a Member from reducing its settlement activity during a time of stress primarily to limit its Loss Allocation Cap.

(5) Loss Allocation Withdrawal Notice and Loss Allocation Cap

NSCC's current loss allocation rules allow a Member to withdraw if the Member notifies NSCC, within 10 business days after receipt of notice of a pro rata charge, of its election to terminate its membership and thereby avail itself of a cap on loss allocation. The proposed change would shorten the withdrawal notification period from 10 business days to five business days, and would also change the beginning of such notification period from the receipt of the notice of a pro rata charge to the issuance of the notice.²⁵ Each round would allow a Member the opportunity to notify NSCC of its election to withdraw from membership after satisfaction of the losses allocated in such round. Multiple Loss Allocation Notices may be issued with respect to each round to allocate losses up to the round cap.

Pursuant to the proposed change, in order to avail itself of its Loss Allocation Cap, a Member would be able to elect to withdraw from membership by following the requirements in proposed Section 6 of Rule 4: (1) specify in its Loss Allocation Withdrawal Notice (as defined below) an effective date of withdrawal, which date shall be no later than 10 business days following the last day of the applicable Loss Allocation Withdrawal Notification Period (as defined below) (i.e., no later than 10 business days

²⁵ NSCC states that setting the start date of the withdrawal notification period to the date of issuance of a notice would provide a single withdrawal timeframe that would be consistent across the Members.

after the fifth business day following the first Loss Allocation Notice in that round of loss allocation);²⁶ (2) cease all activity that would result in transactions being submitted to NSCC for clearance and settlement for which such Member would be obligated to perform, where the scheduled final settlement date would be later than the effective date of the Member's withdrawal; and (3) ensure that all clearance and settlement activity for which such Member is obligated to NSCC is fully and finally settled by the effective date of the Member's withdrawal, including, without limitation, by resolving by such date all fails and buy-in obligations.

Under the current Rules, a Member's cap on loss allocation is its Required Deposit as fixed immediately prior to the time of the pro rata charge. Under the proposal, the first round and each subsequent round of loss allocation would allocate losses up to a round cap of the aggregate of all Loss Allocation Caps of those Members included in the round. In addition, a Member that withdraws in compliance with proposed Section 6 of Rule 4 would remain obligated for its pro rata share of losses and liabilities with respect to any Event Period for which it is otherwise obligated under Rule 4;²⁷ however, its aggregate obligation would be limited to the amount of its Loss Allocation Cap as fixed

²⁶ NSCC states that having an effective date of withdrawal that is not later than 10 business days following the last day of the Loss Allocation Withdrawal Notification Period would provide Members with a reasonable period of time to wind down their activities at NSCC while minimizing any uncertainty typically associated with a longer withdrawal period.

²⁷ For the avoidance of doubt, pursuant to Section 13(d) of Rule 4(A) (Supplemental Liquidity Deposits), a Special Activity Supplemental Deposit of a Member may not be used to calculate or be applied to satisfy any pro rata charge pursuant to Section 4 of Rule 4. Supra note 10.

in the round for which it withdrew.²⁸ If the first round of loss allocation does not fully cover NSCC's losses, a second round would be noticed to those Members that did not elect to withdraw from membership in the previous round; however, the amount of any second or subsequent round cap may differ from the first or preceding round cap because there may be fewer Members in a second or subsequent round if Members elect to withdraw from membership with NSCC as provided in proposed Section 6 of Rule 4 following the first Loss Allocation Notice in any round. To the extent that a Member's Loss Allocation Cap exceeds the Member's Required Fund Deposit on the first day of the applicable Event Period, NSCC may in its discretion retain any excess amounts on deposit from the Member, up to the Member's Loss Allocation Cap.

(6) Declared Non-Default Loss Event

Aside from losses that NSCC might face as a result of a Defaulting Member Event, NSCC could incur non-default losses incident to its clearance and settlement business.²⁹ The Rules currently permit NSCC to apply the Clearing Fund to non-default losses. Specifically, pursuant to Section 2(b) of Rule 4,³⁰ NSCC can use the Clearing Fund to satisfy losses or liabilities of NSCC incident to the operation of the clearance and settlement business of NSCC. Section II of Addendum K of the Rules provides

²⁸ If a Member's Loss Allocation Cap exceeds the Member's then-current Required Fund Deposit, it must still cover the excess amount.

²⁹ Non-default losses may arise from events such as damage to physical assets, a cyber-attack, or custody and investment losses.

³⁰ Current Section 2(b) of Rule 4 provides that "the use of the Clearing Fund...shall be limited to satisfaction of losses or liabilities of the Corporation incident to the operation of the clearance and settlement business of the Corporation other than losses and liabilities of a System." Supra note 10.

additional details regarding the application of the Clearing Fund to losses outside of a System.

NSCC proposes to enhance the governance around non-default losses that would trigger loss allocation to Members by specifying that the Board of Directors would have to determine that there is a non-default loss that may be a significant and substantial loss or liability that may materially impair the ability of NSCC to provide clearance and settlement services in an orderly manner and would potentially generate losses to be mutualized among the Members in order to ensure that NSCC may continue to offer clearance and settlement services in an orderly manner. The proposed change would provide that NSCC would then be required to promptly notify Members of this determination, which would be referred to as a Declared Non-Default Loss Event. In addition, NSCC proposes to specify that a mandatory Corporate Contribution would apply to a Declared Non-Default Loss Event prior to any allocation of the loss among Members, as described above. Additionally, NSCC proposes language to clarify Members' obligations for Declared Non-Default Loss Events.

B. Changes to Align the Loss Allocation Rules

The proposed changes would align the loss allocation rules, to the extent practicable and appropriate, of the three DTCC Clearing Agencies so as to provide consistent treatment for firms that are participants of multiple DTCC Clearing Agencies. As proposed, the loss allocation process and certain related provisions would be consistent across the DTCC Clearing Agencies to the extent practicable and appropriate.

C. Accelerated Return of Former Member's Clearing Fund Deposit

NSCC proposes to reduce the time in which NSCC may retain a Member's Clearing Fund deposit. Specifically, NSCC proposes that if a Member gives notice to NSCC of its election to withdraw from membership, NSCC would return the Member's Actual Deposit in the form of (1) cash or securities within 30 calendar days and (2) Eligible Letters of Credit within 90 calendar days, after all of the Member's transactions have settled and all matured and contingent obligations to NSCC, for which the Member was responsible while a Member, have been satisfied, except that NSCC may retain for up to two years the Actual Deposits from Members who have Sponsored Accounts at DTC.

NSCC states that shortening the time for the return of a Member's Clearing Fund deposit would be helpful to firms that have exited NSCC, so that such firms could have use of the deposits sooner than under the current Rules. However, such return would only occur if all obligations of the terminating Member to NSCC have been satisfied, which would include both matured as well as contingent obligations.

D. Conforming and Technical Changes

NSCC proposes to make various conforming and technical changes necessary to harmonize the remaining current Rules with the proposed changes. The proposed defined terms in the loss allocation process would be included in Rule 1 (Definitions and Descriptions), and obsolete terms would be replaced with the proposed terms. In addition, the rule numbers appearing in the remaining current Rules would be updated to reflect the changes made by the proposal. NSCC further proposes to modify its Voluntary Termination process to avoid any potential conflicts with the loss allocation process.

II. Discussion and Commission Findings

Although the Clearing Supervision Act does not specify a standard of review for an advance notice, its stated purpose is instructive: to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for systemically important financial market utilities and strengthening the liquidity of systemically important financial market utilities.³¹

Section 805(a)(2) of the Clearing Supervision Act³² authorizes the Commission to prescribe risk management standards for the payment, clearing and settlement activities of designated clearing entities engaged in designated activities for which the Commission is the supervisory agency. Section 805(b) of the Clearing Supervision Act³³ provides the following objectives and principles for the Commission’s risk management standards prescribed under Section 805(a):

- to promote robust risk management;
- to promote safety and soundness;
- to reduce systemic risks; and
- to support the stability of the broader financial system.

The Commission has adopted risk management standards under Section 805(a)(2) of the Clearing Supervision Act³⁴ and Section 17A of the Act³⁵ (“Rule 17Ad-22”).³⁶

³¹ See 12 U.S.C. 5461(b).

³² 12 U.S.C. 5464(a)(2).

³³ 12 U.S.C. 5464(b).

³⁴ 12 U.S.C. 5464(a)(2).

³⁵ 15 U.S.C. 78q-1.

Rule 17Ad-22 requires registered clearing agencies to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for their operations and risk management practices on an ongoing basis.³⁷ Therefore, it is appropriate for the Commission to review proposed changes in advance notices against the objectives and principles of these risk management standards as described in Section 805(b) of the Clearing Supervision Act³⁸ and against Rule 17Ad-22.³⁹

A. Consistency with Section 805(b) of the Clearing Supervision Act

The Commission believes that the proposed changes in the Advance Notice are designed to help NSCC promote robust risk management, promote safety and soundness, reduce systemic risks, and support the stability of the broader financial system as discussed below.

NSCC proposes to make the following changes to its loss allocation process as described above. First, NSCC would apply a mandatory fixed percentage of its General Business Risk Capital Requirement as compared to the current Rules, which provide for a “no less than” percentage of retained earnings. The proposed changes also would clarify that the proposed Corporate Contribution would apply to Declared Non-Default Loss Events, as well as Defaulting Member Events, on a mandatory basis. Moreover, the proposal specifies that if the Corporate Contribution is applied to a loss or liability

³⁶ 17 CFR 240.17Ad-22.

³⁷ Id.

³⁸ 12 U.S.C. 5464(b).

³⁹ 17 CFR 240.17Ad-22.

relating to an Event Period, then for any subsequent Event Periods that occur during the 250 business days thereafter, the Corporate Contribution would be reduced to the remaining, unused portion of the Corporate Contribution. The Commission believes that these changes set clear expectations about how and when NSCC's Corporate Contribution would be applied to help address a loss, and allow NSCC to better anticipate and prepare for potential exposures that may arise during an Event Period.

Second, as described above, NSCC proposes to determine a Member's loss allocation obligation based on the average of its Required Fund Deposit over a look-back period of 70 business days and to determine its Loss Allocation Cap based on the greater of its Required Fund Deposit or the average thereof over a look-back period of 70 business days. These proposed changes are designed to allow NSCC to calculate a Member's pro rata share of losses and liabilities based on the amount of risk that the Member brings to NSCC. Moreover, using a look-back period to determine a Member's loss allocation obligation is designed to deter Members from reducing their settlement activities during a time of stress primarily to limit their Loss Allocation Caps. As a result of these changes, the Commission believes that NSCC should be in a better position to manage its risk by curtailing the chance that reduced settlement activities contribute to higher volatility or lower liquidity during an already stressed period.

Third, as described above, NSCC proposes to introduce the concept of an Event Period, which would group Defaulting Member Events and Declared Non-Default Loss Events occurring within a period of 10 business days for purposes of allocating losses to Members in one or more rounds. Under the current Rules, every time NSCC incurs a loss or liability, NSCC will initiate its current loss allocation process by applying its retained

earnings and allocating losses. The current Rules do not contemplate a situation where loss events occur in quick succession. Accordingly, even if multiple losses occur within a short period, the current Rules dictate that NSCC start the loss allocation process separately for each loss event. Having multiple loss allocation calculations and notices from NSCC and withdrawal notices from Members after multiple sequential loss events could cause operational risk to NSCC, since multiple notices may cause confusion at a time of significant stress.

The Commission believes that the proposed change to introduce an Event Period would improve upon the current loss allocation process described immediately above. Specifically, the introduction of an Event Period would provide a more defined and transparent structure than the current loss allocation process. Such an improved structure should enable both NSCC and each Member to more effectively manage the risks and potential financial obligations presented by sequential Defaulting Member Events or Declared Non-Default Loss Events that are likely to arise in quick succession, and could be closely linked to an initial event and/or market dislocation episode. In other words, the proposed Event Period structure should help clarify and define for both NSCC and Members how NSCC would initiate a single defined loss allocation process to cover all loss events within 10 business days. As a result, all loss allocation calculation and notices from NSCC and potential withdrawal notices from Members would be tied back to one Event Period instead of each individual loss event.

Fourth, as described above, the proposal would improve upon the approach laid out in NSCC's current Rules by providing for a loss allocation round, a Loss Allocation Notice process, a Loss Allocation Withdrawal Notice process, and a Loss Allocation Cap.

A loss allocation round would be a series of loss allocations relating to an Event Period, the aggregate amount of which would be limited by the round cap. When the losses allocated in a round equals the round cap, any additional losses relating to the Event Period would be allocated in subsequent rounds until all losses from the Event Period are allocated among Members. Each loss allocation would be communicated to Members by the issuance of a Loss Allocation Notice. Each Member in a loss allocation round would have five business days from the issuance of such first Loss Allocation Notice for the round to notify NSCC of its election to withdraw from membership with NSCC, and thereby benefit from its Loss Allocation Cap. The Loss Allocation Cap of a Member would be equal to the greater of its Required Fund Deposit on the first day of the applicable Event Period and its Average RFD. Members would have two business days after NSCC issues a first round Loss Allocation Notice to pay the amount specified in such notice.

The Commission believes that those four proposed changes, to (1) establish a specific Event Period, (2) continue the loss allocation process in successive rounds, (3) clearly communicate with its Members regarding their loss allocation obligations, and (4) effectively identify continuing Members for the purpose of calculating loss allocation obligations in successive rounds, are designed to make NSCC's loss allocation process more certain. In addition, the changes are designed to provide Members with a clear set of procedures that operate within the proposed loss allocation structure, and provide increased predictability and certainty regarding Members' exposures and obligations. Furthermore, by grouping all loss events within 10 business days, the loss allocation process relating to multiple loss events can be streamlined. With enhanced certainty,

predictability, and efficiency, NSCC would then be able to better manage its risks from loss events occurring in quick succession, and Members would be able to better manage their risks by deciding whether and when to withdraw from membership and limit their exposures to NSCC. Furthermore, the proposed changes are designed to reduce liquidity risk to Members by providing a two-day window to arrange funding to pay for loss allocation, while still allowing NSCC to address losses in a timely manner.

Fifth, as described above, NSCC proposes to clarify the governance around Declared Non-Default Loss Events by providing that the Board of Directors would have to determine that there is a non-default loss that may be a significant and substantial loss or liability that may materially impair the ability of NSCC to provide its services in an orderly manner. NSCC also proposes to provide that NSCC would then be required to promptly notify Members of this determination and start the loss allocation process concerning the loss stemming from a Declared Non-Default Loss Event.

The Commission believes that the immediately above described changes should provide an orderly and transparent procedure to allocate a non-default loss by requiring the Board of Directors to make a definitive decision to announce an occurrence of a Declared Non-Default Loss Event, and requiring NSCC to provide a notice to Members of such decision. The Commission further believes that an orderly and transparent procedure should result in a risk management process at NSCC that is more robust as a result of enhanced governance around NSCC's response to non-default losses, thereby promoting safety and soundness.

Collectively, the Commission believes that the proposed changes to NSCC's loss allocation process would provide greater transparency, certainty, and efficiency to both

NSCC and Members regarding the amount of resources and the instances in which NSCC would apply such resources to address risks arising from Defaulting Member Events and Declared Non-Default Loss Events, which could occur in quick succession. The Commission believes that such transparency, certainty, and efficiency would allow better predictability to NSCC and its Members regarding their exposures, and in turn, would allow a risk management process at NSCC and its Members that is more robust in response to such events and would improve their ability to continue to operate and recover in a safe and sound manner during such events. Therefore, the Commission believes that the proposal promotes robust risk management as well as safety and soundness.

In addition to the key changes discussed above, NSCC proposes to align the loss allocation rules of the DTCC Clearing Agencies to the extent practicable and appropriate. The alignment is designed to help provide consistent treatment for firms that are participants of multiple DTCC Clearing Agencies. The Commission believes that providing consistent treatment through consistent procedures among the DTCC Clearing Agencies would help firms that participate in multiple DTCC Clearing Agencies from encountering unnecessary complexities and confusion stemming from differences in procedures regarding loss allocation processes, particularly at times of significant stress. Accordingly, the Commission believes that the change is designed to reduce systemic risk and support the stability of the broader financial system.

Furthermore, NSCC proposes to reduce the time within which NSCC is required to return a former Member's Clearing Fund deposit that is cash or securities from 90 days to 30 calendar days. The Commission believes that this reduction in time would enable

firms that have exited NSCC to have access to their funds sooner than under the current Rules. While acknowledging that the reduction in time could lesson NSCC's flexibility in liquidity management for the period between 31 calendar days and 90 days, the Commission believes that NSCC's procedures would continue to protect NSCC and its clearance and settlement services because a Member's Clearing Fund deposit would only be returned if all obligations of the terminating Member to NSCC have been satisfied. Therefore, NSCC could maintain necessary coverage for possible claims arising in connection with the NSCC activities of a former Member. Accordingly, the Commission believes that the proposed changes to accelerate the return of a former Member's Clearing Fund deposit are designed to reduce the systemic risks by reducing financial risks for participants of multiple DTCC Clearing Agencies, and in turn, support the stability of the broader financial system.

Finally, NSCC proposes to make conforming and technical changes necessary to harmonize the current Rules with the proposed changes. The Commission believes that these changes are designed to provide clear and coherent Rules concerning loss allocation process to NSCC and its Members. The Commission further believes that clear and coherent Rules should help enhance the ability of NSCC and Members to more effectively plan for, manage, and address the risks and financial obligations that loss events present to NSCC and its Members. Accordingly, the Commission believes that the conforming and technical changes are designed to promote robust risk management.

Therefore, for all of the reasons stated above, the Commission believes that the changes proposed in the Advance Notice are consistent with the objectives and principles of Section 805(b) of the Clearing Supervision Act.⁴⁰

B. Consistency with Rule 17Ad-22(e)(4)(viii)

Rule 17Ad-22(e)(4)(viii) under the Act requires, in part, that a covered clearing agency⁴¹ establish, implement, maintain and enforce written policies and procedures reasonably designed to effectively identify, measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes, including by addressing allocation of credit losses the covered clearing agency may face if its collateral and other resources are insufficient to fully cover its credit exposures.⁴²

As described above, the proposal would revise the loss allocation process to address how NSCC would manage loss events, including Defaulting Member Events. Under the proposal, if losses arise out of or relate to a Defaulting Member Event, NSCC would first apply its Corporate Contribution. If such funds prove insufficient, the proposal provides for allocating the remaining losses to the remaining Members through

⁴⁰ 12 U.S.C. 5464(b).

⁴¹ A “covered clearing agency” means, among other things, a clearing agency registered with the Commission under Section 17A of the Exchange Act (15 U.S.C. 78q-1 et seq.) that is designated systemically important by the Financial Stability Oversight Counsel (“FSOC”) pursuant to the Clearing Supervision Act (12 U.S.C. 5461 et seq.). See 17 CFR 240.17Ad-22(a)(5) and (6). On July 18, 2012, FSOC designated NSCC as systemically important. U.S. Department of the Treasury, “FSOC Makes First Designations in Effort to Protect Against Future Financial Crises,” available at <https://www.treasury.gov/press-center/press-releases/Pages/tg1645.aspx>. Therefore, NSCC is a covered clearing agency.

⁴² 17 CFR 240.17Ad-22(e)(4)(viii).

the proposed process. Accordingly, the Commission believes that the proposal is reasonably designed to manage NSCC's credit exposures to its Members, by addressing allocation of credit losses.

Therefore, the Commission believes that NSCC's proposal is consistent with Rule 17Ad-22(e)(4)(viii) under the Act.⁴³

C. Consistency with Rule 17Ad-22(e)(13)

Rule 17Ad-22(e)(13) under the Act requires, in part, that a covered clearing agency establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure the covered clearing agency has the authority to take timely action to contain losses and liquidity demands and continue to meet its obligations.⁴⁴

As described above, the proposal would establish a more detailed and structured loss allocation process by (1) modifying the calculation and application of the Corporate Contribution; (2) introducing an Event Period; (3) introducing a loss allocation round and notice process; (4) implementing a look-back period to calculate a Member's loss allocation obligation; (5) modifying the withdrawal process and the cap of withdrawing Member's loss allocation exposure; and (6) providing the governance around a non-default loss. The Commission believes that each of these proposed changes helps establish a more transparent and clear loss allocation process and authority of NSCC to take certain actions, such as announcing a Declared Non-Default Loss Event, within the loss allocation process. Further, having a more transparent and clear loss allocation

⁴³ Id.

⁴⁴ 17 CFR 240.17Ad-22(e)(13).

process as proposed would provide clear authority to NSCC to allocate losses from Defaulting Member Events and Declared Non-Default Loss Events and take timely actions to contain losses, and continue to meet its clearance and settlement obligations.

Therefore, the Commission believes that NSCC's proposal is consistent with Rule 17Ad-22(e)(13) under the Act.⁴⁵

D. Consistency with Rule 17Ad-22(e)(23)(i) and (ii)

Rule 17Ad-22(e)(23)(i) under the Act requires that a covered clearing agency establish, implement, maintain and enforce written policies and procedures reasonably designed to publicly disclose all relevant rules and material procedures, including key aspects of its default rules and procedures.⁴⁶ Rule 17Ad-22(e)(23)(ii) under the Act requires that a covered clearing agency establish, implement, maintain and enforce written policies and procedures reasonably designed to provide sufficient information to enable participants to identify and evaluate the risks, fees, and other material costs they incur by participating in the covered clearing agency.⁴⁷

As described above, the proposal would publicly disclose how NSCC's Corporate Contribution would be calculated and applied. In addition, the proposal would establish and publicly disclose a detailed procedure in the Rules for loss allocation. More specifically, the proposed changes would establish an Event Period, loss allocation rounds, a look-back period to calculate each Member's loss allocation obligation, a withdrawal process followed by a loss allocation process, and a Loss Allocation Cap that

⁴⁵ Id.

⁴⁶ 17 CFR 240.17Ad-22(e)(23)(i).

⁴⁷ 17 CFR 240.17Ad-22(e)(23)(ii).

would apply to Members after withdrawal. Additionally, the proposal would align the loss allocation rules across the DTCC Clearing Agencies to help provide consistent treatment, and clarify that non-default losses would trigger loss allocation to Members. The proposal would also provide for and make known to members the procedures to trigger a loss allocation procedure, contribute NSCC's Corporate Contribution, allocate losses, and withdraw and limit Member's loss exposure. Accordingly, the Commission believes that the proposal is reasonably designed to (1) publicly disclose all relevant rules and material procedures concerning key aspects of NSCC's default rules and procedures, and (2) provide sufficient information to enable Members to identify and evaluate the risks by participating in NSCC.

Therefore, the Commission believes that NSCC's proposal is consistent with Rules 17Ad-22(e)(23)(i) and (ii) under the Act.⁴⁸

⁴⁸ 17 CFR 240.17Ad-22(e)(23)(i) and (ii).

III. Conclusion

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Clearing Supervision Act,⁴⁹ that the Commission DOES NOT OBJECT to advance notice SR-NSCC-2017-806, as modified by Amendment No. 1, and that NSCC is AUTHORIZED to implement the proposal as of the date of this notice or the date of an order by the Commission approving proposed rule change SR-NSCC-2017-018, as modified by Amendment No. 1, whichever is later.

By the Commission.

Eduardo A. Aleman,
Assistant Secretary.

⁴⁹ 12 U.S.C. 5465(e)(1)(I).

